

# Hong Kong (SAR) Tax Alert

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## The Hong Kong SAR and Croatia entered into a double tax agreement

### Summary



The Hong Kong SAR (Hong Kong) recently signed a comprehensive double taxation agreement (CDTA) with Croatia. Benefits under the CDTA for Hong Kong residents include reduced withholding tax (WHT) rates for dividends, interest and royalties and a better protection from creating a permanent establishment (PE) in Croatia.

Hong Kong signed a CDTA with Croatia<sup>1</sup> on 24 January 2024. It represents the 48<sup>th</sup> CDTA signed by Hong Kong. The CDTA will enter into force after completion of the ratification procedures in both Hong Kong and Croatia. The earliest possible effective dates of the CDTA will be from taxable year beginning on or after 1 January 2025 in Croatia and from the year of assessment 2025/26 (which begins on 1 April 2025) in Hong Kong.

### Key features of the CDTA

#### Persons covered (Article 1)

- A provision dealing with transparent entities is included to the effect that treaty benefits will not be granted to income derived by or through a fiscally transparent entity or arrangement where neither Contracting State treats, under its domestic tax law, the income as the income of a resident of it<sup>2</sup>.

#### Tax residency (Article 4)

- An entity (1) incorporated / constituted in Hong Kong or (2) incorporated / constituted outside Hong Kong but normally managed or control in Hong Kong will be a Hong Kong resident.
- For an entity with dual residency (i.e. being a resident of both Hong Kong and Croatia), it shall be deemed as a resident only of the Contracting State where its place of effective management is situated.

#### Permanent establishment (Article 5)

The definition of PE generally follows that in the OECD Model Tax Convention 2017 and include:

- Fixed place PE – includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well;
- Construction site PE – for building site or construction/installation project that lasts more than 12 months;

<sup>1</sup> The CDTA can be accessed via this [link](#).

<sup>2</sup> The OECD recommended including this provision in a tax treaty under Action 2 of the BEPS 1.0 Action Plan, which deals with hybrid mismatch arrangements. Please refer to the [OECD's final report on BEPS Action 2](#) for more details.

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- Service PE – there is no service PE clause in the CDTA; and
- Agency PE – a Hong Kong resident will constitute an agency PE in Croatia if a person acting in Croatia on behalf of the Hong Kong resident (1) habitually concludes contracts on behalf of that Hong Kong resident or (2) habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by that Hong Kong resident and these contracts are:
  - in the name of the Hong Kong resident;
  - for the transfer of ownership of property (or right to use) owned by the Hong Kong resident; or
  - for the provision of services by the Hong Kong resident,

The PE Article has incorporated the various provisions recommended by the OECD under Action 7 of the BEPS 1.0 Action Plan<sup>3</sup> to tackle artificial avoidance of PE. These include provisions to (1) limit the specific exemptions for “preparatory or auxiliary” activities, (2) tackle fragmentation of activities between closely related parties and (3) narrow the definition of “independent agent”

### Profits from international shipping and air transport (Article 8)

Profits from international shipping and air transport (i.e. operation of ships or aircraft for transport of goods or persons in international traffic) derived by a Hong Kong resident from Croatia will be tax-exempt in Croatia.

### Dividends, interest, and royalties (Article 10, 11 and 12)

The WHT rates on dividends, interest and royalties under (1) the domestic laws of Hong Kong and Croatia and (2) the CDTA are as follows:

	Dividends	Interest	Royalties
<b>Croatia non-CDTA rate (in general)</b>	10%	15%	15%
<b>HK non-CDTA rate</b>	0%	0%	2.475% to 4.95%
<b>HK/Croatia CDTA rate<sup>4</sup></b>	0%/5% <sup>5</sup>	0%/5% <sup>5</sup>	5% <sup>6</sup>

### Capital gains (Article 13)

The CDTA provides a tax exemption in Croatia on the following gains derived by a Hong Kong resident from disposal of shares:

- gains derived from alienation of shares of a non-property rich company (or comparable interests in a partnership or trust) – i.e. with 50% or less of its value derived from immovable property situated in Croatia **at any time during the 365 days preceding the alienation**; and
- gains derived from alienation of shares of a property rich company (i.e. a company with more than 50% of its value derived from immovable property situated in Croatia **at any time during the 365 days preceding the alienation**) under the following circumstances:
  - alienation of shares listed on a recognised stock exchange; or
  - alienation of shares under a reorganisation of a company, a merger, a scission or any similar operations.

### Elimination of double taxation (Article 22)

Under the CDTA, double taxation in Hong Kong will be eliminated by way of tax credit – i.e. any Croatia taxes paid under the laws of Croatia and in accordance with the CDTA in respect of income derived by a Hong Kong resident from Croatia will be allowed as a credit against the tax payable in Hong Kong in respect of that income, subject to a cap of the Hong Kong profits tax payable on that income.

<sup>3</sup> The OECD's final report on BEPS Action 7 can be accessed via this [link](#).

<sup>4</sup> There is a beneficial ownership requirement in the Dividends, Interest and Royalties articles.

<sup>5</sup> The 0% rate applies to dividends / interest paid to the Hong Kong or Croatian government or other specified government bodies. The 5% rate applies to all other cases.

<sup>6</sup> The definition of “royalties” in the CDTA does not include rentals from use of industrial, commercial or scientific equipment.

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### Entitlement to benefits (Article 27)

The CDTA has incorporated the “principal purposes test” for preventing treaty shopping which applies generally to all articles in the CDTA. Accordingly, a treaty benefit will be denied if it is reasonable to conclude that obtaining such benefit is one of the principal purposes of any arrangement or transaction.

### KPMG observations

We welcome the signing of the CDTA between Hong Kong and Croatia, which is one of the Belt and Road countries.

Under the CDTA, Hong Kong resident companies may benefit from (1) the reduced WHT rates on dividends, interest and royalties derived from Croatia and (2) a better PE protection in Croatia (e.g. the threshold period for creating a construction site / installation project PE in Croatia is extended from more than 6 months under the domestic law to more than 12 months under the CDTA). On the other hand, Croatia resident companies may enjoy a tax exemption on their business profits in Hong Kong in the absence of a PE in Hong Kong.

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